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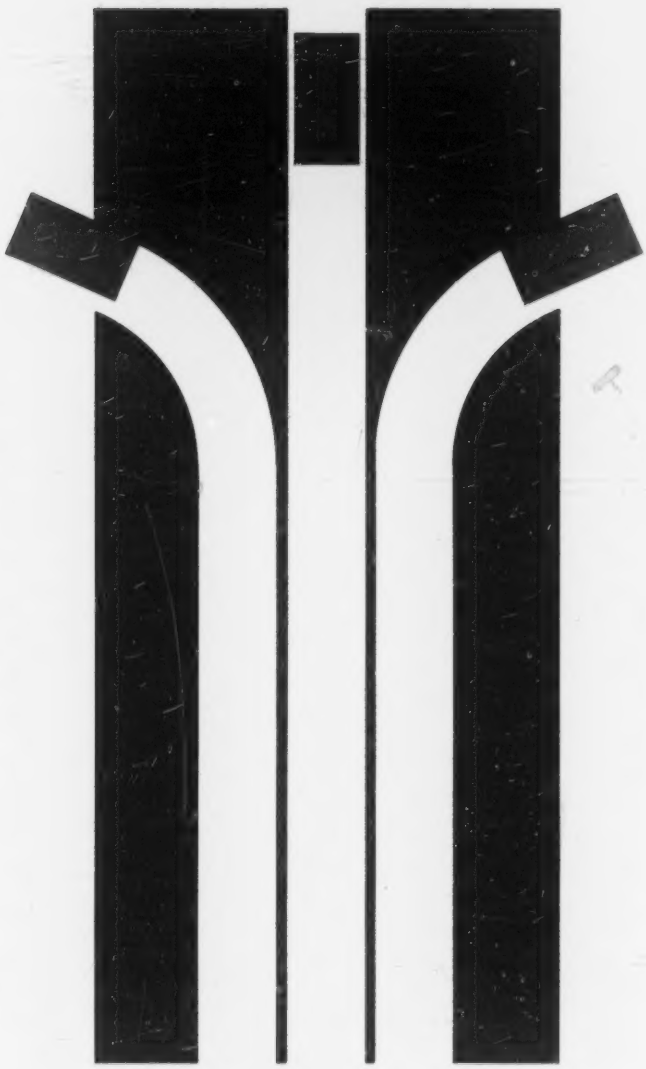
TRENDS IN AUTOMOBILE FINANCING

Results of the 1985/86 Surveys



CBA

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Consumer Bankers Association

Trends in Automobile Financing:

Results of the 1985/86 Surveys

Prepared by

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CBA CONSUMER BANKERS ASSOCIATION

The Association for Retail Banks, Savings & Loans and Credit Unions

THE CONSUMER BANKERS ASSOCIATION

TRENDS IN AUTOMOBILE FINANCING: RESULTS OF THE 1985/86 SURVEYS

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TRENDS IN AUTOMOBILE FINANCING:

RESULTS OF THE 1985/86 SURVEYS

INTRODUCTION

Nineteen eighty-five and 1986 were years of significant changes in the automobile financing and leasing industries. The market for automobile loans had been characterized by consistent growth in outstandings in the 1980s, and banks had historically captured the majority of the auto financing market. The reduced rate financing offered by the American automobile makers in 1986 demonstrated that the captive finance companies could indeed manipulate the market. The resulting market had an incredibly varied degree of impact on the banking industry:

- The promotional expertise and advertising clout of GM, Ford, and Chrysler could not be matched by the fragmented efforts of the banking industry.
- Banks that maintained or increased their share of loans did so by positioning themselves to capture the market that the captive finance companies were not chasing.
- Banks shifted their emphasis to the market for loans for imported cars or used cars.
- Banks that were directly competing in markets targeted by American auto makers saw loan volumes plummet. The shift in market share of new outstandings to captive finance companies indicates the significance of these competitors in the auto loan market.
- Through the use of subvention programs, finance companies, which had received 17 percent of the increase in new loan outstandings during earlier years, captured 69 percent of the market in 1986.

The profitability of the leasing industry has encouraged new entry over the past eight years. Intense competition took place in areas related to price, rate, fee, and term. At the same time, the rush to establish leasing programs has resulted in an industry of relatively inexperienced participants.

The Tax Reform Act of 1986 eliminated the profit cushion generated by investment tax credits (ITCs). As a result, this highly competitive industry will find a profit squeeze in the coming years. Young firms may find their lack of experience in terminating leases to be a disadvantage in efforts to reprice in order to maintain profitability.

The Consumer Bankers Association has taken the lead in tracking the emerging issues in auto financing. For the past eight years they have conducted a survey on the rapidly growing leasing industry. In response to the growing concern of members regarding the degree of change in the auto finance market, CBA retained Furash & Company to expand the leasing survey to include auto lending at both the wholesale and retail levels and to provide an interpretation of survey results. A second goal of this year's survey was to establish a database of information on issues of concern in the auto financing and leasing industries.

The data provided by the completed questionnaires pointed up many differences in the auto financing markets. Sharp contrasts exist among the regions regarding the proportion of banks with leasing programs, the market for import versus domestic cars, and the manner in which an institution approaches the marketplace due to regulatory constraints. Asset size of an institution also seemed to be a delimiter for leasing, as well as dealer wholesaling programs. Despite the differences in market conditions from region to region or between large and small banks, some variations in performance clearly were not market driven. In 1985 and 1986, the most fundamental factor that determined success was an institution's ability to adapt to changes or redirect efforts in areas of greatest opportunity.

Survey Response

Questionnaires were sent to over 350 Consumer Bankers Association members, with 118 respondents returning completed surveys for 1986. Of those completing surveys, 75 percent

were banks or bank holding companies, 13 percent were thrifts, and 12 percent were from other financial institutions such as credit unions. The majority of respondents represented financial institutions of substantial asset size; 40 percent had over $5 billion in assets, with 76 percent over $1 billion.

The primary geographic concentration of institutions responding to the survey was the Eastern United States. Atlantic Coast states (Region 5) had 45 percent of the responding institutions. The Midwest (Region 4) accounted for 26 percent of institutions responding; while the regions representing the Central Plains, Rocky Mountain, and far Western states had 29 percent. This distribution pattern is consistent with that of prior years' surveys.

This distribution provides a sample that is somewhat skewed relative to the banking industry as a whole. In businesses in which size is a prerequisite for getting into the business -- as in establishing wholesale relationships -- the survey information obviously is weighted toward larger institutions. However, in many cases size was a necessary factor for banks to have the capacity to institute new strategies to cope with changing market conditions.

Survey response was much stronger in 1986 than in 1985, primarily due to the timeliness of the 1986 survey. Unfortunately, many of the 1985 questionnaires lacked specific numeric data on volumes, delinquencies, repossessions, and declined ratios. Other 1985 questionnaires reported aggregate figures for loans or leases without providing a delineation of direct or indirect, new or used, and domestic or import categories. For this reason much of the comparison of 1985 versus 1986 data has been limited to an aggregate basis. In several instances figures reported for 1985 are based on a limited number of responses.

Regional Market Differences

There are clear differences in market perception from region to region and among banks of different sizes. Some of these differences stem from regulatory factors, others are a result of consumer preferences and behavior. The major differences in consumer attitudes found among regions centered in two areas: (1) consumer preference for domestic versus imported cars; and (2) the market for leasing, which is more established in western states. The regulatory environment also is decidedly different from region to region. The central

portion of the country has a disproportionate share of unit banking and limited branching states, whereas far western states have a greater percentage of states with statewide branching authority or interstate banking legislation in place. When institutions were asked to describe the geographic distribution of their organization, one-fifth described themselves as interstate, 30 percent as state regional operations, and 29 percent as statewide organizations. In the Rocky Mountain and Pacific Coast institutions, 75 percent and 81 percent, respectively, characterized themselves as either statewide or interstate.

Throughout the Central Plains and Midwest institutions, 60 percent and 61 percent of respondents classified themselves as either single market or concentrated state regional markets. The Atlantic Coast had a more even distribution among categories. It is not surprising, therefore, that 40 percent of Rocky Mountain and Pacific Coast institutions operate separate leasing or financing divisions or departments, compared to 16 percent of Central and Midwest Region banks. The administrative responsibility of directing a statewide or interstate loan operation might require a higher level of expertise than a unit banking operation or limited region program. Conversely, 44 percent of Central and Midwest respondents were consolidated under a larger unit versus 24 percent of western banks. The restrictions applied by unit banking or limited branching states in the middle of the country have had an impact on how institutions approach the auto financing and leasing businesses from a marketing perspective. Banks in unit banking states generally have indirect loan programs in order to build efficient levels of loan volumes. Banks with statewide or regional networks of 300 to 500 branches can build their volume through direct promotions.

Leasing Participation

Geography also had an impact on the mix of business for respondents. Overall, 54 percent of institutions that answered the survey indicated that they engaged in lending and leasing activities. The western states have a larger proportion of banks in both areas, with 65 percent involved in leasing. This ratio drops to 48 percent for the midwestern states of Region 4. Of the 17 percent of respondents indicating that they will begin leasing programs in 1987, 74 percent were from Midwest and East Coast states. It seems clear that while western banks may have been more rigorous in developing the auto leasing business initially, eastern banks are moving to enter the business.

Asset size was also evident as a delimiter of leasing involvement. For banks with less than $5 billion in assets, on average 33 percent were involved in leasing. For banks with $5 billion or more in assets, 63 percent had leasing programs. These data suggested that size may represent a barrier to entry from the standpoint of systems capabilities, operational staff size, or even support staff to develop a program.

Although there were distinct differences in markets and product mix, overall the respondents indicated a sense of optimism. Ninety-seven percent of respondents said they would maintain their programs in both lending and leasing. Eighty-eight percent said that they expected the business to stay the same or get better in 1987. Of the 12 percent who felt business would decrease, western banks expressed pessimism in leasing while the majority of those who felt lending would deteriorate were eastern banks.

I. AUTO FINANCING

The optimism expressed in the survey runs contrary to perceptions in the marketplace. Reduced rate financing offered in 1986 by the captive finance companies of American automobile manufacturers has had a negative impact on lending portfolios of banks. When comparing total loan portfolio size of survey respondents for 1985 and 1986, volume decreased by 2.3 percent. One explanation may be that this sense of optimism may reflect a view that the auto loan market cannot get much worse. In addition, many banks also have had sufficient time to develop alternative strategies to counteract subvention programs. Their optimism may mean they believe they are better prepared to deal with market changes in 1987. Irrespective of the reasons that underlie this optimism, one factor is certain -- if most banks are poised to improve their share of the market, intense competition will be a significant issue for most members.

In analyzing specific geographic market areas, no clear trends relate loan volumes to size or location. When asked to compare new loan volumes in 1986 to 1985, 51 percent of respondents reported an average increase of 31 percent while 49 percent reported an average decrease of 24 percent. In general, it appears there were neither good nor bad markets for auto loans in 1986. Banks that responded to the needs of their particular market, or adapted their strategies to accommodate the environment, fared well. Banks that anticipated business as usual suffered a poor year in auto lending.

Three major areas appear to determine a bank's ability to generate auto loan volume in 1986: (1) existence of an indirect lending network; (2) the availability of a market for imported cars; and (3) movement into the used car market.

Dealer Relationships

For those banks with strong dealer relationships, subvention programs definitely stimulated what had been a sluggish automobile market. Campaigns brought consumers who were ready to buy into the showrooms. Consumers who were disappointed to find that dealer incentives were more promotion than substance, often were persuaded to take the rebate and to finance through banks that had indirect dealer relationships.

This may, in part, explain why the average loan size in existing portfolios decreased from $7,208 in 1985 to $6,460 in 1986. Banks that did not have indirect lending programs found walk-in business greatly reduced. For respondents who maintained indirect dealer relationships, 70 percent recorded average increases of 35 percent in new indirect loans. For direct lending programs, 65 percent of respondents had an average decrease of 24 percent in new loans in 1986.

Import Cars

The shrinking opportunities in domestic auto financing encouraged banks to emphasize financing for import cars in 1986. The percentage of import auto loans in the average portfolio increased from 45 percent in 1985 to 48 percent in 1986. As banks courted the import dealerships, indirect portfolio ratios shifted from 46 percent import in 1985 to 53 percent import in 1986, and total used car portfolios shifted from 40 percent import in 1985 to 54 percent import in 1986. It is difficult to determine how much of the shift in portfolio alignment was due to decreasing domestic loans versus increasing import loans. Nonetheless, the movement in indirect loans, especially used car loans, provides an indication that banks were actively developing relationships with import car dealers. Although geographic regions were not a determinant of loan volumes, loan mix varied drastically by region. The Midwest Regions (Regions 4 and 3) had 60 percent and 57 percent of portfolios, respectively, in domestic auto loans. The Rocky Mountain and Pacific Coast Regions (Regions 2 and 1) had 32 percent and 44 percent, respectively, of their portfolios in domestic loans. It would seem that western banks would have been better able to maintain their volumes due to the high concentration of import loans, but this was not supported by the data.

Used Cars

The used car market boomed in 1986. Two-thirds of banks surveyed had an average increase of 49 percent in used car volume. This may also have contributed to the decline in the amount of the average loan outstanding. Not surprisingly, as the mix of used car loans increases in a portfolio, average loan size decreases. Consumers taking advantage of factory incentives had a secondary impact on the rapid growth in the number of used cars traded. The lack of financing incentives for used cars meant that auto dealers and consumers turned to banks for loans. Once again, banks that recognized this trend maintained, or even increased, the size of their portfolios.

Credit Quality

Credit quality suffered during 1986 as banks scrambled to maintain market share. The increased competition created by the captive finance companies put a new type of pressure on the size of the existing portfolio. The erosion of loan volume by automobile finance companies left a smaller pool of loan applications. In order to replace run-off volume and increase overall outstandings, respondents approved a larger percentage of applications -- 69 percent in 1986 versus 61 percent in 1985. This increased rate of approval did not correlate to size of institution or geographic area of the country according to the responses that were received. Approval rates appear to reflect the aggressiveness of the organization and its willingness to accept the credit that was available.

The resulting delinquencies for 1986 were in line with 1985 figures. Total delinquencies averaged 1.88 percent across all regions, with distinct differences in average indirect delinquencies (2.18 percent) versus average direct delinquencies (1.68 percent). This difference in delinquencies was most striking in the Pacific Coast banks, which had a rate of 1.32 percent for direct portfolios and 3.17 percent for indirect portfolios. The overall delinquency rate was highest, at 2.60 percent, in the Central Plains states and lowest, 1.66 percent, in the Atlantic Coast states. Based on a limited response, the average loss provision and actual losses for 1986 were both 1.10 percent of average net outstandings. Repossessions appear to have climbed from 1985 to 1986 as a percentage of dollar volume. Among survey respondents, repossessions were .76 percent of new car loans in 1986; used car repossessions averaged .90 percent in 1986. The rise in repossessions may be a result of the increased approval rate. It could also indicate a shift in the market. If the captive finance companies are offering reduced rates to the most qualified applicants, are banks going to be forced to accept higher risk applications to maintain (or grow) portfolios?

Financing Terms and Policies

Most of the 1985 and 1986 survey results indicated "business as usual" terms and policies. The amount of down payment required remained relatively stable, with 56 percent of new loans financing 85 percent or more of the total cost of a car. Although 75 percent of banks surveyed offered a 60-month loan, the average new car loan remained at 50 months for 1985 and 1986. There was a difference in average term for new

direct versus indirect loans in 1986. Average term for direct loans was 49 months while indirect loans averaged 52 months. Despite a consistency in the term of new loans, the average portfolio turnover decreased from 32 months to 29 months. This trend in decreasing turnover may accelerate over the next two or three years as consumers lose tax benefits on interest payments and pay off loans early.

Summary

In general, the figures for loan outstandings reported by survey respondents were in line with Federal Reserve statistics for 1986 automobile loans. The federal statistics can be misleading, however. What is not apparent from the government statistics is the wide variation between bullish performances and dismal showings. If the survey response is any indication, the 6 percent increase in outstandings reported by the Fed might stem from half of all banks averaging a 30 percent increase in outstandings and half averaging a 24 percent decrease. The auto loan market was certainly not uniform. Administration of loan portfolios has remained consistent in term, down payment, turnover, delinquencies, losses, and other parameters. The difference in 1986 has been in the marketing effort -- knowing the market and responding to it. This is apparent in the focus on indirect programs, in the increase in used car financing, in the shift in portfolio mix to import cars, and in the loosening of the approval process. The market for 1987 is expected to mirror the reduced rate financing environment of 1986. The ability to adapt and respond to the marketplace once again will determine who will be successful in 1987.

II. AUTO LEASING

For the past eight years leasing has been a rapidly growing industry. The increase in the number of institutions that have leasing programs testifies to the popularity of the leasing business. Of those responding, 53 percent were engaged in auto leasing activities, an increase of 8 percentage points over 1985 and more than double the 26 percent of respondents in auto leasing in 1983. Almost half of those in leasing have been in the business less than five years, with one third less than three years. The average age of leasing programs for all surveyed institutions was eight years.

The relative immaturity of this business means over one-third of participants have a limited understanding of the profitability or risk in their portfolios since they have not had leases go full terms. Leasing, as an industry, has an inherent element of uncertainty due to residual values of a car and methods of disposal. This uncertainty has been heightened by the 1986 tax legislation that removed the investment tax credit and accelerated depreciation benefits. The substantial paper profits created by tax credit benefits which buoyed leasing profitability will evaporate. Leasing, as a product, will have to stand on its own profit contribution. Just as banks were beginning to gauge their profitability they are now forced to reevaluate their programs.

The majority of those responding indicated a concentration in indirect leasing, with 89 percent offering an indirect closed-end lease and 44 percent offering the open. Few were involved with direct leasing; 21 percent offered direct closed-end leases and 16 percent direct open-end. Research suggests and these data confirm that consumers do not shop for a lease in the same manner as a loan. Most banks rely on their dealer relationships to sell leases to consumers. An important feature for the consumers who are candidates for leases is the size of the monthly payment. If the monthly payment is considerably lower than that of a loan, the consumer generally does not question the rate.

As with auto financing, banks that were engaged in leasing in 1986 found the industry to be either very good or very poor. Of those responding, 65 percent experienced a decrease in volume that averaged 43 percent for both direct and indirect

leasing. Of those recording gains, the average was 55 percent. The response from all who provided figures in both 1985 and 1986 shows an average 9.6 percent decrease in lease outstandings at year-end 1986.

While it is difficult to ascertain all of the factors that contributed to the loss of leasing volume for survey respondents, several factors seem clear. Certainly the auto market in general was lackluster in 1986. The low financing incentives offered by the American auto companies meant that consumers could negotiate monthly loan payments, that resulted in owning the auto, which made these payments more comparable to the generally lower leasing payments. This will become an even more important issue as banks reprice lease products to compensate for the loss of investment tax credits.

A second factor is the increasing importance of used car leases in bank portfolios. Forty-one percent of respondents offered used car leases in 1986, up slightly from the 37 percent who did so in 1985. A third alternative might be the erosion of the market caused by pure competition. As more organizations move into leasing, there will be a decrease of existing portfolios due to competition for new leases. While the consensus is that the leasing market will continue to grow, the battle will be for market share. The lack of ITCs as well as altered depreciation will mean squeezed profitability as competition intensifies. As tax legislation and intense competition erode margins, the challenge for maintaining profitable margins in the coming years will be formidable.

Credit Quality

Despite increasing competition within the leasing industry, the rate of approval on lease applications has remained relatively stable, decreasing slightly from 51 percent in 1985 to 47 percent in 1986. The stability in approvals has not been matched by the delinquency rate for leases. At 2.46 percent of total leases, delinquencies for all leases in 1986 were substantially higher than the 1.97 percent recorded in 1985. Indirect leases had a delinquency rate of 2.41 percent of total leases compared to 2.54 percent for direct leases. The rise in delinquencies also may be a result of this broadening of the market. Leasing, which was once an industry reserved for businesses, organizations, and affluent consumers, has become a mass market industry. The average portfolios consisted of 75 percent consumer leases in 1986, with many banks reporting a portfolio of 100 percent consumer leases. This trend should continue as more and more dealers

take advantage of opportunities to increase their sales of new cars by offering consumers low monthly payments and limited initial investment.

Not surprisingly, loss provisions and write-offs have increased as delinquencies have risen. Loss provisions have climbed from an average .85 percent of average net outstandings in 1983 and 1984 to 1.10 percent in 1986. Actual losses as a percentage of average net outstandings have increased from .47 percent in 1984 to .93 percent for survey respondents in 1986. Although the approval rate has remained stable, the expanding market and increased competition are prompting a relaxation of standards in evaluating applications, which is resulting in increased delinquencies and losses.

Leasing Terms and Policies

The important role of the auto dealer in indirect leasing appears to have had an impact on both the term of a lease and terminations. As dealers depend more and more on the amount of the monthly payment as a selling tool, the term of new leases has stretched. In 1985, a new lease term averaged 46 months. In 1986, it climbed to 48 months. For the past two years, a 48-month lease averaged 36 months until termination. In 1986, this had expanded to 38 months. For consumers, the attraction obviously is a lower monthly payment while acquiring a new car before reaching term. In light of this trend, more and more banks are adding a termination fee, increasing from 44 percent in 1985 to 58 percent in 1986. Similarly 70 percent of banks responding allowed third party assumptions of original lease contracts, charging an average fee of $150 for the transaction. For two-thirds of the assumptions a new lease contract was established, while in one-third of the situations the bank kept the original lessee obligated. When asked what percentage of leases terminated before maturity, three-quarters of respondents indicated that less than 30 percent of total leases did so in 1986.

For those lessees that maintained a lease to term, banks use several options to deal with the automobile. Two-thirds of respondents indicated a willingness to allow extensions beyond the original term. For leases that reached term in 1986, 9 percent were extended, 16 percent renegotiated to a new lease, 11 percent converted to a car loan, and 65 percent were paid off for cash.

The opportunities for improving leasing profitability were constrained by the Tax Reform Act of 1986. The loss of the ITC, coupled with the increasing competition in the industry,

will work to squeeze profits in the future. Opportunities for increasing profitability which have not been tapped by a number of banks appear to exist in fees associated with a number of operating characteristics of leases -- applications fees, insurance, and termination fees. Surprisingly, 75 percent of banks do not require lease application fees. Although the number of banks offering insurance has grown from zero percent in 1983 to 30 percent in 1986, 70 percent of banks in leasing still do not offer insurance. The number of banks that do not require a termination fee still hovers near 55 percent.

Consumer Issues

An issue for banks to consider is the amount of disclosure they make in lease arrangements. Disclosure requirements are an emerging consumer issue in most areas of consumer banking. Leasing may be next. The Consumer Leasing Act of 1977 requires a minimum of information from lessors for consumer leases. For example, 48 percent of banks do not disclose the capital cost in their leases. The average maximum capitalized costs for the average bank in 1986, as a percent of manufacturers suggested retail price, was 106 percent. This average represented a range from 95 percent to 120 percent. Based on the survey, roughly half of those in leasing do not disclose the capital costs of a lease. This may be an area that will invite new regulation if banks do not regulate themselves.

Summary

In summary, the leasing industry can be characterized as a young industry that only recently has begun to be concerned about profitability. Companies entered the industry to capture depreciation benefits, the investment tax credit, and to some extent product profitability. Most had relatively little concern for year-to-year product profitability because of overriding tax benefits. As tax benefits waned in portfolios, a new batch of leases bolstered profits. Leasing was so profitable on the front end (due primarily to bookkeeping practices) that companies entered the market with little concern for the profitability of a mature portfolio. As competition intensified, the battle was waged on rates, fees, and payments; with the ITC supporting the profitability of the business to the bank.

With the passage of the Tax Reform Act of 1986, the tax benefits have been eliminated. What remains is an extremely competitive industry that has an untested understanding of the potential profitability of the base product. To maintain or

improve profit margins on the businesses, banks must reevaluate pricing strategies, including rates, fees, and residual values. The pressure to reprice is occurring at a time of growing concern among consumers regarding disclosure of leasing terms. Nineteen eighty-seven will be a year that truly challenges leasing program managers to maintain the profit levels of the past.

III. WHOLESALING

Wholesaling is the first stage in developing a dealer relationship. Despite its importance, there is little published information available. The 1985-1986 Consumer Bankers Association Auto Finance and Leasing Surveys represent one of the first efforts to establish a database of information. With few exceptions, responses for 1985 and 1986 were virtually mirror images. Wholesale financing may provide the foundation for building a broader, more profitable dealer relationship that provides derivative consumer loans. Floor planning loans average $1.9 million. More importantly, a truly cohesive relationship with a dealer can result in a conversion of wholesale units to retail loans. Of those responding to the survey, 66 percent offered floor planning services to dealers. All financed 100 percent of the manufacturer's invoice for new units. The average bank maintained floor planning relationships with 40 dealerships, but the numbers ranged from a single dealership to a high of 385. The average dollar volume per dealership was $1.9 million, again ranging from a low of $400,000 to a high of $7,000,000.

Information that changed, as expected from 1985 to 1986, related to retail loan conversion. On average, the number of wholesale units that became retail loans was 27 percent in 1986, down from 35 percent in 1985. Surprisingly, some banks still managed to convert over three-fourths of wholesale units to retail loans, and almost one-fifth had a conversion rate greater than 50 percent. Banks with superior conversion figures ranged in size from less than $500 million to greater than $25 billion, and in location across all regions surveyed. Once again, the implication is that success does not depend on positioning in a specific geographic area or on attaining a specific size, but upon a knowledge of the needs of the market served and the ability to adapt to those needs.

Half of the banks that provide new car floor planning also have wholesale services for used cars. The average volume per dealership was $250,000. Banks providing car floor planning, on average, maintained relationships with 32 dealers.

Dealer Relationships

In the past year, the importance of dealer relationships became apparent as banks with indirect loan programs were significantly better at attracting auto loan volumes than banks without. No doubt, banks with floor planning programs in place for used cars found it much easier to shift emphasis to the used car market when new car loans began moving to the captive finance companies.

In the coming years, consumers may regard the dealer showroom as the best place to obtain financing for auto loans through either a dealer relationship with a bank, finance company, or leasing agency. Banks that have not cultivated that relationship may find themselves at a disadvantage in the auto financing marketplace.

IV. CONCLUSION

The past two years in the auto financing industry can be described as years of incredible change. Reduced rate financing (subvention), offered by the captive finance subsidiaries of American automobile manufacturers, caught most financial institutions by surprise and has eroded banking's share of outstanding loans. This, coupled with the Tax Reform Act of 1986, created an environment that has many financial institutions perplexed and apprehensive regarding future direction of the industry.

Through the use of subvention programs, the finance companies established control over the auto financing market. The control is not without a price. The question that is asked for 1987 is whether auto makers are willing to erode profits further by offering reduced rate financing again. Initial promotions have emphasized extended warranty coverage, rebates, and discounts on option packages. If these measures do not succeed in stimulating the market, can another round of subvention activity be far behind? Popular opinion seems to believe that there will be significant rate reductions in 1987 by the auto makers.

Perhaps a more important question relates to the actual consumer. Have increased promotions conditioned the American consumer to postpone an auto purchase until there is a promotion? If this is the case, bankers may find that they are increasingly dependent on automobile manufacturers to generate loan volumes and they are increasingly vulnerable to erosion of loan volumes in areas targeted by captive finance units.

One important characteristic of banks that have had success in maintaining loan volumes has been dealer relationships at the wholesale and retail levels. Dealer floor planning appears to be the first step in establishing a relationship, in addition to representing a good source of loan volume. Most banks surveyed indicated that a proportion of floor planned units generally become retail loans, either through a retail indirect program or through referral. The retail indirect relationship proved to be a crucial element in the auto loan program in 1986.

Subvention eroded market share from banks, but it also served as a general promotional tool for the automobile industry. Consumers attracted to the showroom, who were not interested in specific models covered by reduced rates or who did not want the length of term offered on loans, generally could be

sold a longer term loan or a more desired model with bank financing. In those instances it was the bank with established dealer relationships that benefitted. The future success in automobile lending for banks may be tied to the ability of an organization to establish a successful dealer network.

The leasing industry has been one of rapid growth and high profitability. The passage of the Tax Reform Act of 1986 eliminated the profit buffer that had come with the ITC and depreciation structure. The relative inexperience of leasing participants will hinder many efforts to reprice the product in the new environment. This will be complicated by the intense competition that will work to keep prices down. The leasing industry will be faced with the prospect of reduced margins in coming years.

For lessors, a more positive element of the Tax Reform Act was the elimination of interest rate deductibility on income taxes for consumers. This could encourage more people to consider leasing as an alternative to purchasing. The automobile lending and leasing industries have both changed drastically during 1986. For many Consumer Bankers Association members, 1987 will be a year that will require a strategic reevaluation of lending and leasing programs to address the challenges that must be met in the coming years.

The following tables and graphs will offer a more detailed picture of some of the trends in auto financing and leasing, as well as an indication of the differences that exist in regional product mix.

TABLES AND GRAPHS

Table 1

COMPARISON OF GEOGRAPHIC DISTRIBUTION OF RESPONDENTS
BY SIZE OF INSTITUTION
1986

Region	Under $500M	$500M - $999.9M	$1B - $4.99B	$5B - $24.99B	$25B+*
1. Pacific Coast	1	1	5	4	4
2. Rocky Mountain	-	1	4	1	2
3. Central Plains	1	2	2	1	4
4. Midwest	7	-	10	10	4
5. Atlantic Coast	7	8	19	17	5

* Some respondents in this size category indicated a national or multi-regional presence. Eleven total institutions actually responded.

The distribution of organizations responding was skewed toward larger banks and the eastern half of the country. This was similar to the distribution in previous surveys.

Table 2

MARKET CONCENTRATION OF RESPONDENTS BY REGION
AS PERCENT OF TOTAL REGION
1986

	1 Pacific Coast	2 Rocky Mountain	3 Central Plains	4 Midwest	5 Atlantic Coast
Single Market	6%	12%	20%	16%	11%
Concentrated State Regional	6%	-	40%	45%	25%
Diverse State Regional	-	12%	-	6%	11%
Statewide	60%	50%	10%	16%	25%
Interstate	27%	25%	30%	16%	29%
	100%	100%	100%	100%	100

The restrictions on statewide branching by many states may influence the perception of the market a particular bank feels it should be dealing with.

Table 3

PERCENTAGE OF RESPONDENTS ENGAGED IN
LEASING/LENDING ACTIVITY BY GEOGRAPHIC DISTRIBUTION
1986

	1 Pacific Coast	2 Rocky Mountain	3 Central Plains	4 Midwest	5 Atlantic Coast	Total
Offer Leasing & Lending	66%	62%	50%	48%	52%	54%
Offer Lending	34%	38%	50%	52%	48%	46%

The western half of the country has developed leasing programs in far greater proportion than the east. Of those indicating plans to enter leasing in 1987, 74% were from the Atlantic Coast and Midwest Regions (5 and 4).

Table 4

PERCENTAGE OF RESPONDENTS ENGAGED IN
LEASING/LENDING ACTIVITY BY ASSET SIZE OF INSTITUTION
1986

	Under $500M	$500M - $999.9M	$1B - $4.99B	$5B - $24.99B	$25B+*
Offer Leasing & Lending	38%	34%	39%	68%	64%
Offer Lending Only	62%	66%	61%	32%	36%

Asset size appears to be a factor in the development of leasing programs for respondents.

Table 5

PERCENTAGE OF RESPONDENTS
WHO DO BUSINESS WITH LEASE BROKERS
1986

By Region

1 Pacific Coast	2 Rocky Mountain	3 Central Plains	4 Midwest	5 Atlantic Coast
70%	60%	20%	53%	48%

By Size

Under $500M	$500M - $999.9M	$1B - $4.99B	$5B - $24.99B	$25B+*
33%	0	56%	52%	86%

The western United States appears to be more progressive in establishing relationships with lease brokers. Similarly there is an indication that there may be size considerations in dealing with lease brokers.

Table 6

RESPONDENTS OPERATING SEPARATE
INDIRECT DEPARTMENT
1986

By Region

1 Pacific Coast	2 Rocky Mountain	3 Central Plains	4 Midwest	5 Atlantic Coast	Total
37%	33%	45%	43%	37%	37%

By Size

Under $500M	$500M - $999.9M	$1B - $4.99B	$5B - $24.99B	$25B+*	Total
31%	25%	34%	50%	45%	37%

The implications are that larger banks have more of a tendency to establish a separate indirect banking unit. This may be strictly for administrative reasons or it may be to accommodate interstate activity. Regions 3 and 4, which have had a high concentration of unit banking and limited branching state, may have established proportionately more indirect departments as a means to gather loans within the state.

Table 7

PROPORTION OF DOMESTIC AUTO LOANS BY REGION
1986

	1 Pacific Coast	2 Rocky Mountain	3 Central Plains	4 Midwest	5 Atlantic Coast
Direct	44%	32%	65%	69%	59%
Indirect	49%	29%	40%	56%	61%
Total	47%	30%	54%	63%	60%

Figures based on limited response.

Table 8

LOAN APPROVAL RATIO BY REGION
1986

	1 Pacific Coast	2 Rocky Mountain	3 Central Plains	Midwest	5 Atlantic Coast
Direct	73%	49%	60%	68%	74%
Indirect	59%	46%	50%	69%	65%
Total	69%	47%	55%	69%	68%

Figures based on limited response.

Table 9

AVERAGE LOAN DELINQUENCIES BY REGION
1986

	1 Pacific Coast	2 Rocky Mountain	3 Central Plains	4 Midwest	5 Atlantic Coast	All Regions
Direct	1.32%	2.14%	2.22%	1.76%	1.57%	1.68%
Indirect	3.17%	3.05%	3.20%	2.06%	1.80%	2.18%
Total	1.90%	2.54%	2.60%	1.88%	1.66%	1.88%

Indirect loans had a significantly higher delinquency rate than direct loan portfolios, in spite of the fact that the approval ratio for indirect loans implied a more stringent review process. There appear to be distinct regional differences in delinquencies. The economic troubles in the Central Plains may be responsible for the high rate of delinquency.

Table 10

AVERAGE TERM OF NEW AUTO LOAN BY REGION
1986

	1 Pacific Coast	2 Rocky Mountain	3 Central Plains	4 Midwest	5 Atlantic Coast	All Regions
	months	months	months	months	months	months
Direct	51	50	50	50	48	49
Indirect	52	52	52	54	51	52
Total Region	52	51	51	52	49	50.

The increased term of indirect loans indicates the emphasis being placed on selling monthly payments by dealers who may be developing these loans for customers who are marginally qualified for credit.

Table 11

AVERAGE LOAN PORTFOLIO TURNOVER BY REGION
1986

	1 Pacific Coast	2 Rocky Mountain	3 Central Plains	4 Midwest	5 Atlantic Coast	All Regions
	months	months	months	months	months	months
Direct	33	23	37	31	27	30
Indirect	31	32	33	34	30	31
Total Region	32	29	35	32	28	31

The trend appears to be for consumers to establish a long-term loan and to have smaller monthly payments; and to turn the loan over by either trading in or paying it off.

Figures based on limited response.

Table 12

AVERAGE LOAN SIZE BY REGION
1986

	1 Pacific Coast	2 Rocky Mountain	3 Central Plains	4 Midwest	5 Atlantic Coast	All Regions
New Direct	$11,427	$10,950*	$10,659	$10,668	$11,026	$10,958
New Indirect	$ 9,618*	$ 8,505	$ 9,503	$11,362	$11,062	$10,704
Used Direct	$ 4,524*	$ 6,077*	$ 6,500*	$ 4,815	$ 5,651	$ 5,278
Used Indirect	$ 3,842*	$ 6,434*	$ 5,898*	$ 6,958	$ 7,316	$ 6,878

In general, there were no perceived differences in the new loan sizes for direct versus loans or from region to region.

*Figures based on limited response.

Table 13

POINTS OF INTEREST -- LENDING

Background

The average bank has been involved in automobile lending for 30 years.

12 percent of banks offer only indirect retail auto loans.
29 percent of banks offer only direct retail auto loans.
59 percent of banks have a combined program of direct and indirect auto lending.

Compensation

Average managerial salary for auto lending area is $38,000.
Average administrative salary for auto lending area is $21,400.

Financing

4 percent of new dollar volume was tied to balloon payment programs for those banks responding to the survey.

85 percent of banks required a down payment of 10 percent or more on new cars in both 1985 and 1986. In each year, 43 percent indicated that the average down payment was between 10 percent and 15 percent.

Operations

71 percent of respondents did not use a credit scoring system.

68 percent of banks have their auto lending EDP system integrated with other processing systems.
18 percent maintain a stand-alone system.
7 percent use a service bureau.

Table 14

DISTRIBUTION OF LEASING INVOLVEMENT BY REGION
1986

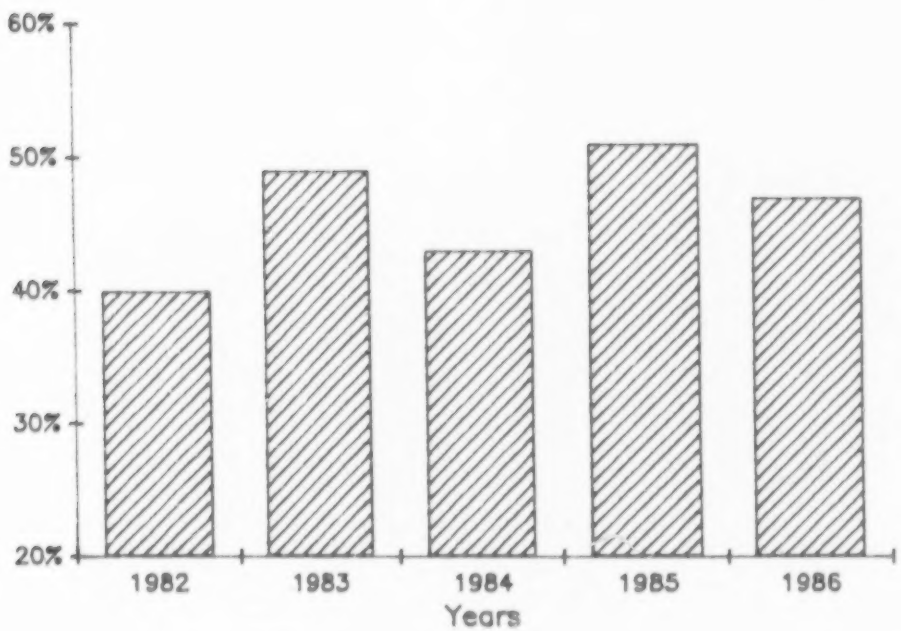
Region	Direct Open	Direct Closed	Indirect Open	Indirect Closed
Pacific Coast	30%	40%	50%	100%
Rocky Mountain	20%	20%	40%	100%
Central Plains	20%	20%	20%	100%
Midwest	13%	13%	53%	87%
Atlantic Coast	14%	28%	24%	86%
Total	16%	21%	44%	89%

The vast majority of banks offer an indirect closed-end lease. In general, the Pacific Coast had a greater proportion of banks participating in all kinds of leasing than other regions.

Only 5% of banks involved in leasing offer leases for RVs. Less than 10% offered Marine leases.

Table 15

DECLINED RATIO FOR LEASE APPLICATIONS



Declined ratios have varied from year to year but the overall trend appears to be toward tighter credit screening.

Table 16

DELINQUENCIES AS A PERCENT OF OUTSTANDING LEASES*

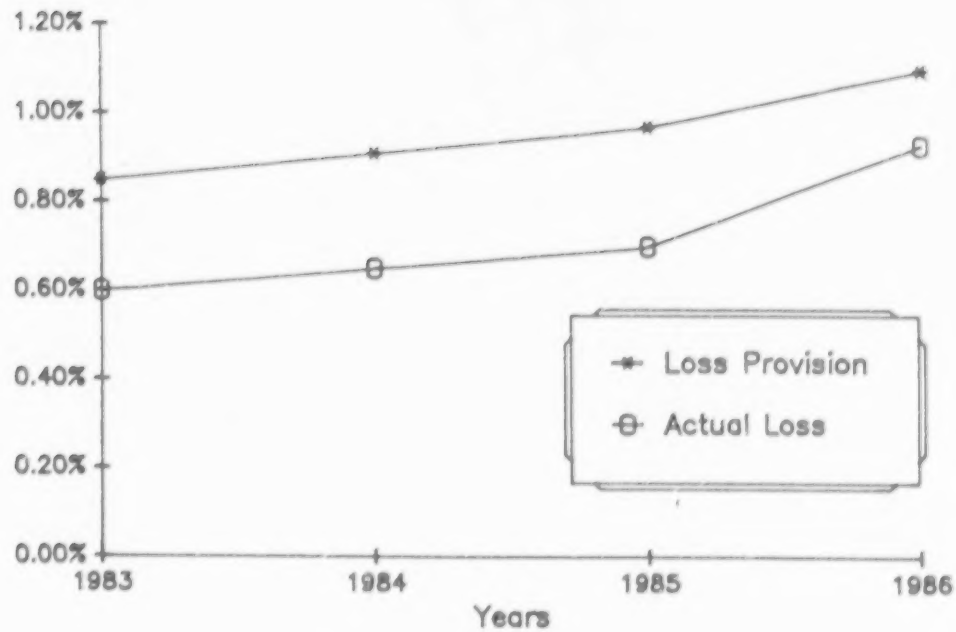
	Direct Closed	Direct Open	Indirect Closed	Indirect Open	All Lease Types
1983	1.99%	1.77%	2.77%	1.51%	2.24%
1984	1.46%	1.36%	2.41%	1.45%	1.97%
1985	NA	NA	NA	NA	NA
1986	2.54%	NA	2.41%	NA	2.46%

* Responses were so limited in 1985 and 1986 surveys as to render most numbers meaningless. It is recommended that 1986 figures be used guardedly.

Table 17

LOSS PROVISION AND ACTUAL LOSSES

As % of Average Net Outstanding Leases



Figures for 1985 and 1986 are based on limited responses and may not accurately reflect the true situation.

Table 18

AVERAGE TERM OF NEW AUTO LEASES

	Direct Closed	Direct Open	Indirect Closed	Indirect Open	All Lease Types
	months	months	months	months	months
1983	40	42	39	42	41
1984	46	40	40	45	44
1985	46	NA	48	47	46
1986	48	43	50	49	48

The trend has been toward increasing terms in all categories of leases. This is particularly evident for indirect leases, where dealers could find the ease of selling a low monthly payment an inducement to expand the term.

Table 19

AVERAGE LENGTH OF TIME OF LEASING
TERMINATIONS FOR VARIED TERMS

Term of Lease	1986	1985
12 months	12 months	12 months
24 months	20 months	22 months
36 months	28 months	27 months
48 months	35 months	35 months
60 months	42 months	45 months
Total	38 months	33 months

The norm appears to be for the consumer to extend the term of the lease to minimize payments and trade the car after a shorter period of time. An increase in the termination fee could extend the average term of the lease and/or generate substantial revenues.

Table 20

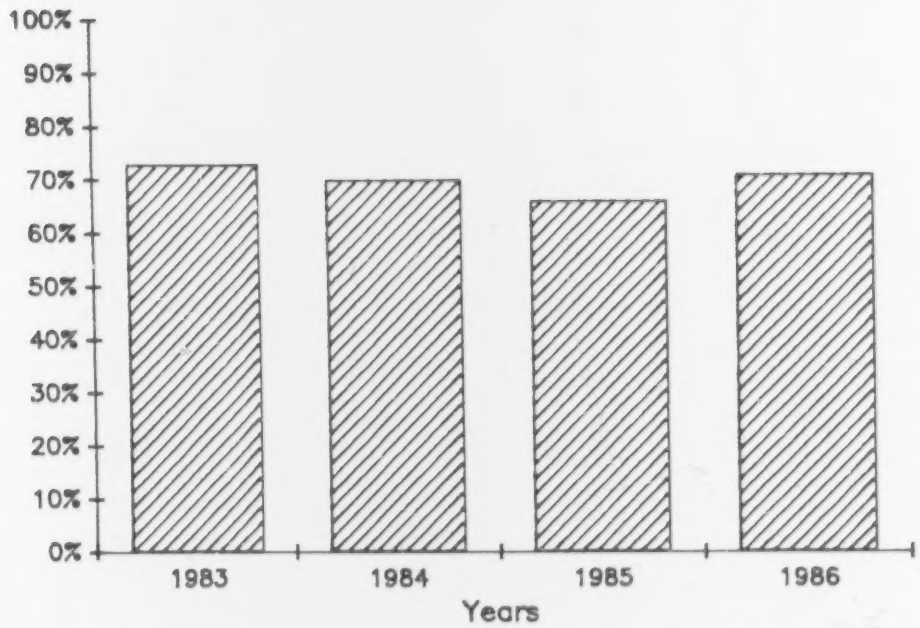
PERCENTAGE OF NEW LEASES
TERMINATED BEFORE THE FIRST YEAR

	1986*	1985*
0 - 5%	78%	75%
6 - 10%	13%	25%
11 - 15%	5%	
16 - 20%	4%	
21%		

*Percentages are from total of banks responding.

Table 21

RESPONDENTS ALLOWING THIRD PARTY
ASSUMPTION OF LEASES

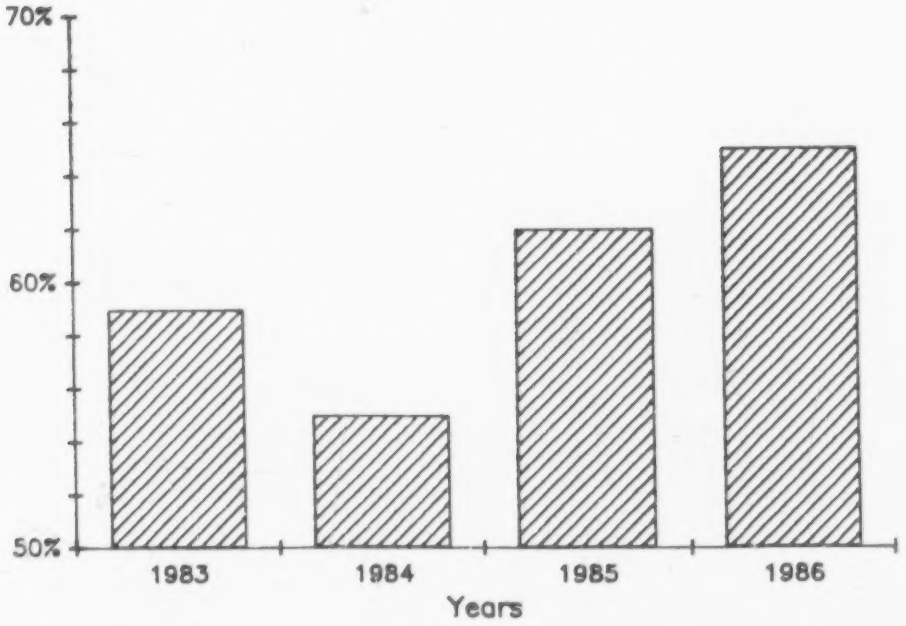


In all years an average of two-thirds of respondents kept the original lessee obligated in a third party assumption.

The average fee for the transaction was $150 and ranged from $50-$250.

Table 22

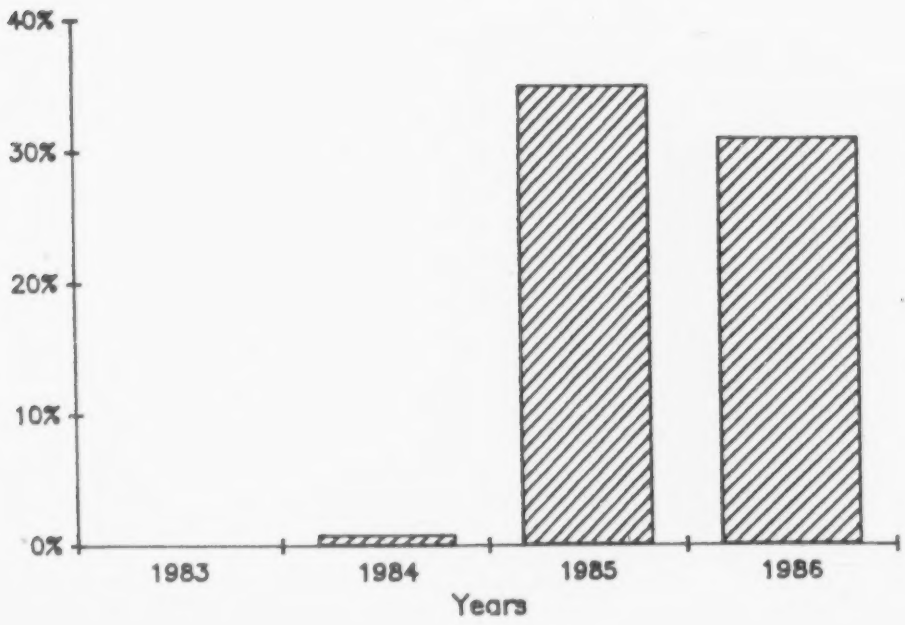
LEASES THAT HAVE EXERCISED
THE PURCHASE OPTION



There has been a trend for an increasing number of lessees to exercise the purchase option. For younger consumers, the purchase option at the end of the lease term may allow them to drive the car they want while they progress financially. Similarly, if the market value of a leased car is greater than the payoff, many will purchase the car for a quick resale.

Table 23

RESPONDENTS OFFERING INSURANCE

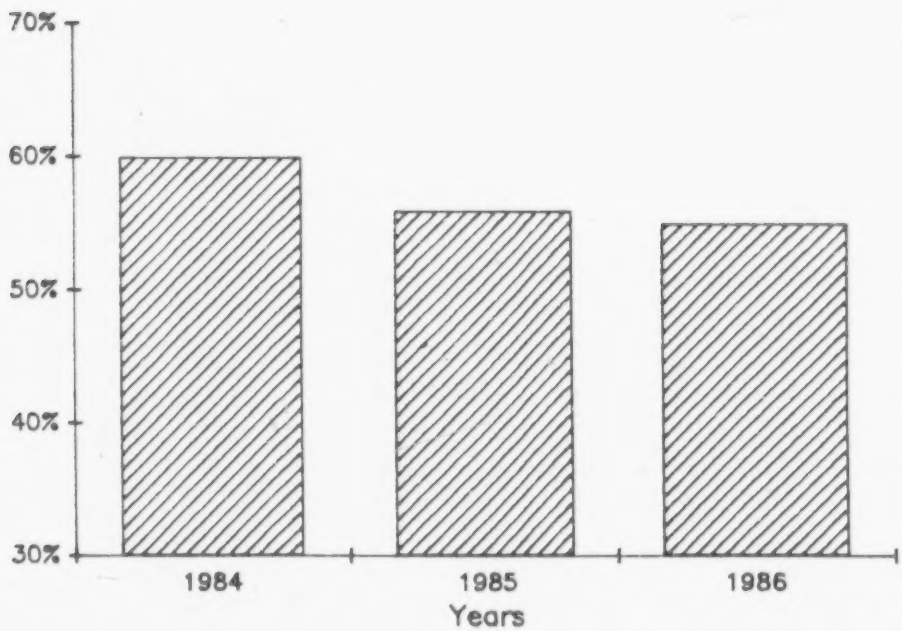


Insurance may increasingly be a source of fee income that is used to improve product profitability as margins are squeezed in the future.

Table 24

DOMESTIC LEASES

As % of Total Leases



The movement toward import leases may be fueled by young consumers acquiring import cars versus a decline in domestic leases.

Table 25

AVERAGE CAPITAL COST PER NEW LEASE

	Direct Closed-End	Direct Open-End	Indirect Closed-End	Indirect Open-End	All Lease Types
1983	$12,774	$12,301	$12,807	$12,550	$12,630
1984	$13,696	$13,779	$13,808	$13,992	$13,830
1985	$14,872	NA	$14,015	$14,762	$14,268
1986	$15,492	$15,679	$15,484	$17,003	$15,969

The average capital cost per new lease has been steadily increasing over the past four years. Part of this increase can be attributed to the rising cost of automobiles. Another element that may boost figures is the tendency to capitalize an increasing number of fees, warranty packages and dealer add-ons. Average maximum capitalized costs were 106 percent of MSRP for survey respondents, and ranged to a high of 120 percent.

Table 26

POINTS OF INTEREST -- LEASING

Compensation

Average salary for leasing managers - $36,000.
Average salary for administrative personnel - $20,000.

Policy

Most respondents used either coupon books or monthly billing for leasing but not both:

55% monthly billing
38% coupon books
7% both

As values of cars have tended to increase, the product has adapted:

37% offered leases for used cars in 1985
41% offered leases for used cars in 1986

55% allowed extensions beyond term in 1985
67% allowed extensions beyond term in 1986

Lease termination fees seemed to be applied by a growing number of institutions.

Insurance

Over the past three years virtually all closed-end leases had residual value insurance purchased for them.

On average, one-third of open-end leases purchased residual value insurance.

The average premium for residual value insurance has consistently averaged 2% of capitalized cost.

Table 27

WHOLESALE RELATIONSHIPS FOR NEW CARS
BY SIZE OF INSTITUTION
1986

	Under $500M	$500M - $999.9M	$1B - $4.99B	$5B - $24.99B	$25B+
Avg. # Accts./ Inst.	11	6	14	82	58
Avg. Gross $ Vol./ Inst.	$8,791,500	$10,815,600	$22,508,476	$134,525,880	$316,304,500
Avg. Gross $ Vol./ Acct.	$ 800,000	$ 1,800.000	$ 1,600,000	$ 1,640,000	$ 5,453,000

The general trend appears to indicate that banks of larger size attract an increasing number of proportionately larger accounts.

Table 28

WHOLESALE RELATIONSHIPS FOR USED CARS
BY SIZE OF INSTITUTION
1986

	Under $500M	$500M - $999.9M	$1B - $4.99B	$5B - $24.99B	$25B+
Avg. # Accts./ Inst.	6	1	4	12	12
Avg. Gross $ Vol./ Inst.	$230,000	$185,000	$285,000	$2,060,000	$2,000,000
Avg. Gross $ Vol./ Acct.	$ 38,000	$185,000	$ 71,000	$ 171,700	$ 166,700

Although the average gross dollar volume per account does not prohibit entry into wholesale used car financing, there appears to be relatively few small banks that have aggressively developed this market.

CONSUMER BANKERS ASSOCIATION
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The Consumer Bankers Association was founded in 1919 to provide a progressive voice for the retail banking industry. CBA represents approximately 700 federally insured banks, savings and loans and credit unions that hold more than 80 percent of all consumer deposits and more than 70 percent of all consumer credit held by federally insured depository institutions.